A Tough Test

It's not easy being a mortgage servicer today. ▲ Mounting delinquencies and foreclosures, rising costs, lower profit margins and a scarcity of experienced collections and loss-mitigation staff are all making the business of mortgage servicing a very tough one. ▲ In recent months, several servicers have found their ratings downgraded or placed on watch lists by the three major rating agencies: Fitch Ratings, Moody's Investors Service and Standard & Poor's (S&P), all based in New York. ▲ *Mortgage Banking* spoke to analysts at the three rating agencies to get their take on the challenges servicers face today, and to see what they look at when making servicer evaluations. ▲ All three agencies evaluate mortgage servicers by looking at a variety of performance metrics, as well as loan administration and default management processes. The financial condition and overall stability of servicers are playing an increasingly important role in servicer evaluations, particularly in the subprime sector, analysts at the agencies say.

Rating agencies are grading servicers on their ability to prevent losses in a really tough environment. Call metrics, financial stability, loss-mitigation results and innovative use of technology are ways servicers are earning good grades despite the challenges.

BY MARY MCGARITY

Finding good staff

"Capacity is a major issue right now," says Richard Koch, director in structured finance ratings with Standard and Poor's. Servicers are challenged to find both skilled in-house staff as well as outside vendors to cope with the mounting number of loans going into delinquency and default, he says.

In the areas of collections and loss mitigation, some servicers have had to increase their in-house staff by from 200 percent to 300 hundred percent, "and in some cases, 500 hundred percent" due to the sudden increase in delinquency and foreclosure volume, Koch says.

"Externally, the servicers are competing for the same vendors that are providing the inspection work, the broker price opinions and the law firms that are processing the foreclosures," Koch says. The shortage of such vendors is particularly felt in places such as California, Nevada and Arizona, he adds—states that have experienced a higher level of delinquencies and foreclosures.

"Servicers are challenged by not only the sheer volume of defaults, but also the speed with which the volume has increased," says Diane Pendley, managing director with Fitch Ratings. "It takes time to find the right staff, train them and put them through a period of oversight before they're ready to take calls," she says.

If it's an option, some servicers are moving origination staff into servicing roles, or are moving customer service staff into collections, says Mary Kelsch, senior director with Fitch. "Most mortgage servicers provide training and a path for people to move up. Perhaps their really good customer service people could move up into early collections. The really good early-collections people could move to late-stage collections, and late-stage staff could move to loss mitigation," she says.

"Good servicers often have a path like that, so when they get busy they can hire people at the customer-service level. It's a little bit easier to train customer service reps and get them up-to-speed quickly," Kelsch says.

In addition to capacity and staffing issues, overall profitability is a major issue facing mortgage servicers today, says William Fricke, vice president, senior credit officer with Moody's Investors Service. "Obviously it's costing more and more to service loans, especially on the default side of the house," Fricke says. "It's something we're watching carefully."

Financial stability

Indeed, the overall financial condition of a mortgage servicing company and/or its parent has become increasingly important in today's tough mortgage market, analysts from all three agencies say.

The financial condition of the servicer is particularly important when Fitch evaluates servicers of non-prime products, Pendley notes. "[Financial stability] is a big piece of our rating for subprime servicers now, due to the liquidity needs of supporting and servicing [subprime loans]—especially with the number of defaults we're seeing today," she says.

Under Fitch's rating model, financial condition is weighted more heavily for a primary servicer of subprime loans than prime loans, Pendley says.

"In the current environment, we've had to unfortunately downgrade a number of servicers. Each time something happens to a parent company, we have to look at that [in terms of financial stability]," Pendley notes.

Any sort of merger or acquisition of a servicer or its parent will obviously call for the ratings agencies to re-evaluate a servicing shop, adds Kelsch. "Even if a company gets their name in the headlines, we have to be on the phone and understand what impact, if any, there might be on their servicing operation," she says.

In today's environment, Fitch is carefully watching how servicers are handling their increased costs, and how their profitability is being affected, Pendley says. "Their contracts are based on an anticipated level of defaults, and I think everyone would agree that those levels were passed quite a while back. How can [servicers] continue to do the same level of work on these loans without being paid more? What that means to their bottom line is something we're watching closely," she says.

How servicers go about staffing and operating their call centers is a vital part of a servicing evaluation, analysts from the rating agencies say.

Financial strength is also playing a more important role in S&P's servicer evaluations, Koch says.

S&P's servicer rankings range from weak, below average, average, above average to strong, he says. The ranking is S&P's assessment of a company's ability to mitigate operational risk, Koch says. "While our ranking process focuses on operational risk mitigation, the financial strength of the servicer plays an important role in the overall analysis," states a 2007 S&P report co-authored by Koch.

Moody's assigns a servicer quality (SQ) rating based on its assessment of a servicer's ability to minimize residential mortgage losses, says Warren Kornfeld, managing director with Moody's. The ratings range from a low of SQ5 to SQ1, he says.

The SQ rating considers the operational and financial stability of a servicer as well as its ability to respond to changing market conditions, according to Moody's servicing-rating criteria.

Moody's is putting more of a focus on servicer stability, Kornfeld says. "That stability encompasses a number of different things, from financial strength to regulatory and legal strength, and the strength of staff and management," he says.

"The trend from a ratings standpoint has been predominantly down," Kornfeld says.

"In the last year, a significant amount of [downgrading] has been stability-driven, and less ability-driven. In this environment, with the challenges that servicers face, we look at whether they will be able to continue to have the same performance that they've had in the past going forward. That has had a greater level of impact on the servicer-quality rating more recently," Kornfeld says.

Call-center metrics

How servicers go about staffing and operating their call centers is a vital part of a servicing evaluation, analysts from the rating agencies say.

S&P looks at a number of metrics related to collections within a servicer's call center, Koch says. Some of those include call-center abandonment rates, average talk times, average speed of answer and average handling time.

As part of its servicer reviews, S&P conducts on-site visits to observe first-hand how a servicer runs its call shop. "We actually sit in the call center and monitor calls randomly. We get a feel for the experience and the education level of the people that are taking the calls from borrowers," Koch says.

Over the last year, S&P has seen those phone calls become longer and more complicated, Koch notes. "Invariably, the type of borrowers that are calling now on the subprime side have serious issues. They're afraid of losing their homes and they're interested in doing some kind of workout. The servicers need to get a lot of financial and other information, so these calls are becoming a lot longer," he explains.

Traditionally, servicing call centers are highly managed in terms of the amount of phone talk time expected of staff, Koch says. "It all relates to the cost of running a call center, and capacity, and knowing how many people you have to hire. In this environment, that becomes very challenging. These calls are going to be longer, more in-depth, and require more expertise."

S&P is watching closely to see whether servicers can adequately staff up and handle the increased number of calls and the more complicated issues presented by callers, according to Koch. "If borrowers are calling to try to work out some sort of loan modification or payment plan, you don't want them hanging up out of frustration because they're on hold for so long," he says.

When developing call-center capacity and staffing plans, servicers need to manage not only outbound calls, but incoming calls from borrowers as well, Koch says. About two years ago, S&P began measuring servicers' metrics on incoming calls in terms of average speed of answer and abandonment rates, Koch says.

"Can people reach [a servicer] after they've been contacted? We were actually kind of surprised to see that some servicers were abandoning 9 [percent] to 10 percent of incoming calls, and the average speed of answer might be a few minutes," Koch says.

Ideally, S&P doesn't like to see an abandonment rate of more than 1 or 2 percent on inbound calls, or more than a 45-second average speed of answer, Koch says.

Answering inbound calls from subprime borrowers is particularly important, agrees Fitch's Pendley. "If you have a subprime borrower actually returning a phone call, the drop time on [answering] those should be almost non-existent," she says.

But reaching borrowers, particularly subprime borrowers, has been a tough task in recent months, adds Kelsch. At a servicer workshop held by Fitch in 2007, one of the biggest topics discussed was the difficulty servicers are having in contacting borrowers, Kelsch notes. "Servicers are unable to reach people at the numbers they had been given. They're calling neighbors, family members, and workplaces trying to reach them. Borrowers are just refusing to call them back," she says.

Fitch collects a good deal of data on a servicer's business before it makes an on-site visit, Pendley says. "There's quite a bit of metrics we can look at before we go on-site that tells us where they're having success and where they are having problems," she says.

Staffing the Problem

Finding and training staff on the loss-mitigation side of the business remains one of the biggest obstacles for servicers, say analysts with the three rating agencies—Fitch Ratings, Moody's Investors Service and Standard & Poor's (S&P), all based in New York. "Servicers are going out after a limited number of resources trying to get skilled and talented default management people, especially in loss mitigation," says Richard Koch, director in structured finance ratings with Standard and Poor's (S&P).

"The toughest problem is getting people with good experience," agrees William Fricke, vice president, senior credit officer with Moody's Investors Service. "It's a little easier from a collections standpoint to shift people around and perhaps move them to the front end. But in loss mitigation, obviously you need people with experience to provide the best possible solutions to borrowers," he says.

Ultimately, Fitch measures a servicer by its overall success in minimizing losses, Kelsch says.

Servicers are facing ever-increasing volume in REO, Fricke says. "Just getting the loans through the pipeline and trying to manage losses is a challenge," he says.

Moody's sees servicers trying different approaches to handling REO, Fricke says. "One example is auctions—trying to liquidate properties on a bulk process, rather than one-by-one. We also see servicers using Internet sites to list properties and sell them over the Internet," he says.

Fitch Ratings looks at staffing, processes and a variety of metrics to determine how successful a servicer is in managing losses, says Mary Kelsch, senior director with Fitch Ratings. "It's a combination of listening to what their story is, meeting the people who are doing the work, looking at the technology and tools they have, and also looking at the metrics," she says.

But ultimately, Fitch measures a servicer by its overall success in minimizing losses, Kelsch says. "You can have great people and a great process, and it's still not working," she says.

Fitch checks to see whether a servicer has been able to successfully get and keep borrowers on a repayment plan, she says. "We look at things like, of all the loans that were delinquent 60 days ago, where are they now?" The rating agency is looking to see whether previous delinquent loans are current, have been modified or paid off, or have gone into the foreclosure process, Kelsch says.

Fitch looks at a wide range of metrics associated with a servicer's calling campaign, including hold times, talk times and hang-ups, Pendley says. "That helps us compare a servicer to what we saw a year prior. We also compare the servicer to other servicers in their peer group. When we go on-site, we can target our questions to areas where we see problems," she says.

Average hold times have gotten longer, but Fitch sees that slowly improving as servicers add and train staff, Pendley says. Fitch considers the type of loan product when evaluating hold times, she says. "For a prime borrower, you might need to get the call within 30 seconds. For a subprime borrower, you might need to get that call within 15 seconds," she says.

Fitch scores each of the factors it reviews from 1 to 5, based on benchmarks set by the best servicer in a particular sector, Pendley says.

Experience and training are key, she adds. "It's hard to find good people now, but it's better to not answer the phone than to put somebody out there who gives the borrower bad information," Pendley says.

Servicers are using outside vendors to help with short-term needs, as well as on a long-term basis, Pendley says. "There are very few servicers that don't outsource at least one function," she adds. Many servicers outsource "non-customer-facing type of work overseas," Pendley says.

While India is well known as a hub for outsourcing, servicers are also using vendors in the Philippines, Mexico and the Caribbean, Pendley says.

Fitch looks carefully at a servicer's oversight and management of outside vendors, according to Pendley. "We want to make sure the vendor [service] is being tested, and that servicers are managing their vendor relationships," she says.

As part of its servicer reviews, Moody's makes a visit to India to visit some of the outsource vendors used there by servicers, Fricke says. "We try to visit on an annual basis as part of our review of the servicer shop. We want to see that [servicers] make sure the vendor is managed properly and are keeping a close eye on those operations," Fricke says.

Moody's uses a number of measurements when reviewing a servicer's collections ability, including right-party contacts, roll rates and the frequency of dropped calls, says Kornfeld. "We focus very significantly on areas where we see negative trends," he says. "We look at how they are maintaining staffing levels, and things like average speed to answer on a monthly basis."

ARM resets and loan modifications

An S&P report published early this year showed resets on adjustable-rate mortgages (ARMs) increasing markedly, Koch notes. S&P's *Servicer Evaluation Spotlight Report* showed that the average monthly increase of adjustable-rate subprime mortgages that reset in the period between January 2007 and September 2007 was 15 percent. The findings were based on aggregated servicer performance data collected by S&P through September 2007.

Along with the increase in ARM resets have been a jump in loan modifications, Koch says. "What I've been hearing from servicers anecdotally is that the sheer volume of loan modifications now has tripled or quadrupled in some cases, especially as these ARM resets are hitting," he says.

The majority of loan modifications have been interest-rate reductions, according to Koch. "To a lesser extent, we've seen principal reductions," he says.

S&P recommends servicers try a stipulation agreement with a delinquent borrower for a period of time before modifying the loan, Koch says. "We think it's pretty prudent to do a stipulation where [the servicer] puts the borrower on a payment plan for three to six months to kind of reinforce the fact that they have the ability to pay, even if it's a lower amount, before you do the modification," Koch says.

But the sheer volume of loans is overwhelming many servicers, Koch adds. "There are so many loans out there hitting their resets, and so many loans going into default, unfortunately. Some servicers feel they really don't have the time or the resources to put [borrowers] on a stipulation. They're just going ahead and doing loan modifications," Koch says.

For the most part, Moody's is seeing modifications where rates are being kept at or close to the teaser rate, Kornfeld says.

"That's of some concern to S&P because you want these loans to be able to perform. You don't want to have borrowers going through perpetual loan modifications," Koch says.

A Moody's survey on the modification practices of subprime mortgage servicers released back in September 2007 showed that most servicers at that time had only modified about 1 percent of their serviced loans that experienced a reset in the months of January, April and July 2007. The survey included data from 16 subprime servicers with a total servicing volume of about $950 billion, according to Moody's.

A follow-up survey in November showed modifications through the end of September 2007 had increased to 3.5 percent, Fricke says. The follow-up survey included information from 12 servicers with total subprime servicing volume of approximately $680 billion. Industry reports since that time have shown a steady increase in loss mitigation activity, including modifications.

Moody's sees more servicers offering a streamlined approach to loan modifications for some borrowers, Fricke says. "Rather than getting the full-blown documentation from the borrowers, we're seeing servicers using a more streamlined approach to qualify borrowers for modifications. As long as it's being done judiciously, in the best interest of the borrower and the trust, we feel that it can be advantageous," he says.

For the most part, Moody's is seeing modifications where rates are being kept at or close to the teaser rate, Kornfeld says. "The principal-forgiveness modifications, which are getting more and more discussion, have been very few to date," Kornfeld says.

Historically, loan modifications haven't been a widely used tool by servicers, notes Fitch's Pendley. "Borrowers who got into difficulty [in previous market cycles] just refinanced. Modifications were negligible. Now that refinancing is often not an option, Fitch is looking at not only the amount of modifications [servicers] are doing, but also the type of modifications, and how successful they are," she says.

Fitch believes most servicers are trying to stick with the modifications that have been endorsed by industry groups like the New York–based American Securitization Forum (ASF) and the Mortgage Bankers Association (MBA).

Fitch sees many servicers extending the initial interest rate on an ARM for up to five years, Pendley says. “That type of modification is something servicers today are very comfortable in doing.”

Some servicers will forgive delinquencies on relatively small amounts in order to get a borrower back on track, Pendley notes. Less common is adjusting the interest rate below the initial rate, she says. “We see a little bit of that, but servicers are still being very careful about making that decision because it goes below the initial contract rate,” she says.

Will modifications work?

How successful are loan modifications? “Historically, modifications haven’t been the best workout tool,” Koch says. S&P data show that more than 20 percent of subprime mortgages with formal loan modifications closed in 2006 re-defaulted between Jan. 1, 2007, and June 30, 2007, he notes.

As part of its evaluation, S&P checks to see whether servicers are making good use of Web technology, Koch says.

In the past, modifications were typically used for borrowers who had an interruption or a reduction in income, Koch notes. “The modification was used to help somebody stay in their home,” Koch says.

“Whether or not modifications are going to help everybody in this environment is open to speculation, especially since a lot of these properties were investor properties that took advantage of the different ARM options,” Koch says.

Loan modifications obviously won’t do any good if there isn’t a borrower living in the property, agrees Fitch’s Kelsch. “That’s the first thing the servicer has to determine: Is a borrower living in the house and do they want to stay? If not, the servicer has to work on an actual liquidation of the property,” she says.

Often the lender or servicer has no choice but to foreclose on a property, adds Pendley. “We keep reminding everybody that even though these foreclosure numbers look really scary, many times there’s nothing else the lender can do but to continue going through with the foreclosure process. Those foreclosure levels will continue to go up as long as there are borrowers who are walking away from their contractual requirements,” Pendley says.

Fitch research shows that borrower and broker fraud accounts for a fairly large component of loans in foreclosure, she says. A research report released in November of 2007 states, “Fitch’s analysis of subprime defaults suggests that lax underwriting and fraud may account for as much as one-quarter of the underperformance of the 2006 vintage of subprime RMBS [residential mortgage-backed securities] transactions.”

Some of the findings in the Fitch research report include apparent fraud in the form of occupancy misrepresentation, poor or lack of underwriting relating to suspicious items on credit reports, and poor underwriting of stated-income loans for reasonability.

Also of concern to S&P is the lack of escrow accounts seen on subprime mortgage loans, Koch notes. In its *Servicer Evaluation Spotlight Report,* released in January, S&P found that at least 60 percent of prime loans had escrow accounts for handling the payment of hazard and flood insurance and property taxes. Less than 40 percent of subprime loans required escrow accounts, S&P found.

That presents a problem for servicers of subprime loans originated without an escrow account, he adds. “It’s very difficult when you’re dealing with a segment of borrowers who are challenged when it comes to managing their finances. You’re looking at a situation when the T&I aren’t always going to be paid, or paid on time, so servicers have to open up forced escrow accounts. Suddenly the borrower’s payment increases,” Koch says.

Turning to technology

To cope with the additional calls coming into call centers, many servicers are relying on various technologies, including voice-response systems or voice-response units (VRUs), S&P’s Koch notes.

S&P measures VRU capture rates, which the agency defines as the percentage of inbound calls routed through the VRU that are successfully completed without further call routing. “That means the VRU was totally self-service and the borrower didn’t have to be transferred to a live person,” Koch says. “Even on the prime side, we never really saw the VRU capture rate rise above 50 [percent] or 60 percent. On the subprime side, it’s substantially lower because most times it’s a more complicated call and they want to talk to a live person,” he says.

As part of its evaluation, S&P checks to see whether servicers are making good use of Web technology, Koch says. “We’re looking very closely at servicers’ use of the Web. [We ask,] ‘Of the total servicing portfolio, how many people have you been successful in signing up on your Web site? What is the usage percentage of your Web site?’”

Fitch looks at a servicer’s technology from a number of standpoints, Kelsch says. “At the highest level, we’re looking for some sort of disaster-recovery or business-redemption technology to be in place in case there is a temporary power outage or something more catastrophic,” she says. “If something should happen, [servicers] should be able to continue to accept calls from borrowers.”

In functional areas, Fitch checks to make sure a servicing shop has tools in place that will help make the process of contacting borrowers more efficient, Kelsch says. The technology should also track the information on calls, she adds. “We look for things like identifying borrowers for calling campaigns and connecting with borrowers at good times.”

Servicers are using various skip-tracing technologies to locate and reach borrowers, Kelsch notes. “It’s unbelievable the level of effort these servicers are going through to reach borrowers,” she says.

With regard to loss mitigation, Fitch looks to see that servicers have decisioning technology that will help determine which loss-

mitigation option is the best for each borrower, based on their circumstances and the value of the property, Kelsch says. "We look at: What kinds of tools are they using? How are they using them? What controls do they have around them?"

"We think the loss-mitigation technology is one of the most important tools being used," says Pendley. "Borrowers are being put on various plans with different options. All of that needs to be tracked to show the rating agencies and regulators how [servicers] are working with these borrowers and what's successful. The newer technologies can help them make the right decision on a very specific basis, and help make sure they treat all borrowers fairly," she says.

Adjusting metrics

The benchmarks Fitch uses to rate servicers are adjusted according to market conditions, and those adjustments are happening more quickly in the current market, notes Kelsch. "It's sort of a function of what's going on in the marketplace. We benchmark to the best servicer in a particular sector [for various metrics]," she says.

For example, Fitch has modified the way it views foreclosure and real estate–owned (REO) times, Kelsch says. "Previously when we looked at foreclosure timelines, it was all about being the most efficient and moving the loans through the foreclosure process as quickly as possible. Obviously, foreclosure timelines have been extended and we can't be as stringent as in the benign environment we've had over the past number of years," she says.

Today, Fitch is looking to make sure servicers are looking at all possible alternatives and are working with qualified attorneys, Kelsch says. Fitch has also adjusted its metrics relating to phone calls with borrowers, she adds. "One of the more dramatic metrics is talk time. The average talk time is much longer. Perhaps [servicers] are not answering the phone as quickly, but once they do get the borrower on the phone, the times are much longer," she says.

Where Fitch may have typically adjusted certain metrics on an annual basis, the agency is finding the need to make adjustments at least every six months in today's environment, Pendley adds. "We benchmark to what the reality is, rather than what we sitting in New York think the number should be. As quickly as the market is changing, we need to make adjustments more often," she says.

Over the last year or so, Moody's has changed its approach to rating servicers in a couple of ways, Kornfeld says. It has increased the amount of information it asks from servicers, he says. "We've been receiving loan-level information for quite a few years—we now get that loan-level information monthly. We've increased the number of fields we receive. We're getting more information on modifications, and we're getting more information on workouts," he says.

Think outside the box

Analysts from all three rating agencies view today's environment for mortgage servicing as possibly the most difficult in history. And unprecedented times often call for new and unique approaches to dealing with borrowers and minimizing losses, they say.

While the current climate for servicing is a tough one, "mortgage servicers as a group tend to be problem-solvers," says S&P's Koch. "It's a very challenging environment today for servicers. It's really unprecedented. But I see servicers are out there trying to find new ways of doing things, trying to find new initiatives, new ways to reach out to borrowers," he says.

Going forward, S&P will continue to keep an eye on capacity, technology and the ability of servicers to project volume, he says. "In this environment, there's a lot of regulatory, headline and litigation risk for servicers," Koch says.

Specifically, Koch advises servicing shops to carefully monitor their option-ARM portfolios and the risks inherent in those portfolios. "What percentage of resets will be occurring in 2008, 2009 and 2010? They should be looking at that on a monthly basis," he says.

For resets occurring within the next six months, servicers should be identifying the risks and projecting the potential payment shock, Koch adds. "For instance, if the potential payment shock is greater than 10 percent, how is [the servicer] addressing that?"

Managing vendors will continue to be important, Koch says. Servicers need to have key performance indicators (KPIs) and stringent quality controls in place for outside vendors, he says. "We're hearing from the bench—the federal bankruptcy court—that they're very unhappy with the quality of the paperwork that's being submitted for things like proof of claim. There's a general sloppiness out there," he says.

The best servicers "are proactive. They anticipate and always stay ahead of the curve," says Moody's Fricke. "They have a focus on technology and are as efficient as possible. Those are the ones that seem to be more successful than other servicers," Fricke says.

Fitch's Pendley urges servicers to "think outside the box. Talk to other servicers who are in the same position and try new strategies. This is just a very interesting time in the servicing industry, because there are so many situations that are really very new to the market. Servicers have to be willing to try things that they normally wouldn't entertain," she says.

In turn, the rating agencies are also facing a more challenging task when evaluating mortgage servicers, Pendley adds. "Our jobs have become much more difficult. There's not going to be a lot of history to prove that something works with some of the newer approaches. We also need to be more flexible when assessing servicers." **MB**

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